Members of the Federal Reserve Board met with the Federal Advisory Council on May 11, 2018. During the meeting, Council members commented on recently proposed revisions to the Board's regulatory capital rules to implement the Current Expected Credit Loss (CECL) accounting standard, including CECL's potential effects on bank lending and capital levels. The Council provided the following written comments on the interagency notice of proposed rulemaking (Implementation and Transition of the Current Expected Credit Losses Methodology for Allowances and Related Adjustments and Related Amendments to the Regulatory Capital Rules and Conforming Amendments to Other Regulations (Docket No. R-1605, RIN 7100-AF04)).

<u>**CECL Implementation**</u>

Banks and bank regulators continue to discuss the various challenges that the current expected credit loss (CECL) accounting standards pose to operations, supervision, interaction with stress testing, and the treatment of regulatory capital. What does the Council see as the highest priorities for the banking industry and its regulators for successful implementation of CECL?

The Council sees three top priorities for the banking industry and its regulators to ensure successful implementation of CECL.

1. Ensuring consistency in CECL implementation practices.

Implementation of the new CECL standard allows for variability in the interpretation of how financial institutions employ life-of-loan forecasting methodologies. This variability could lead to a wide range of practices and make financial comparability for similar levels of risk exposure difficult. As an example, analyses performed by some banks in the industry have concluded that CECL reserves can vary dramatically depending on the bank's choice of a time horizon for a "reasonable and supportable" loss forecast before relying on long-term historical information. Similarly, a recent benchmarking study of several banks from various nations subject to IFRS 9 accounting standards published by *The RMA Journal*[1] found that credit loss estimates varied significantly by a factor of 12 to 15 times, on average, for a 12-month expected credit loss (ECL) "for the same hypothetical borrower." These differences occurred due to variability in different methodologies, data sources, and assumptions, even though the banks based their estimates on common macroeconomic forecasts and used a common estimation method. To help narrow the potential variability in implementation and results and to ensure easier financial comparability for similar levels of risk exposure, the Council encourages regulators to consider providing interpretative industry guidelines that will help narrow the range of potential practices, while recognizing the industry's desire to limit pro-cyclical impacts when possible.

2. Providing clear supervisory expectations and guidance for how CECL will intersect with regulatory capital policies and how it will be incorporated into the CCAR process.

[1] *The RMA Journal*, "Credit Loss Estimates Used in IFRS 9 Vary Widely, Says Benchmarking Study," May 2018.

Transitioning from the current incurred-loss approach to CECL, under which banks must immediately book reserves for estimated losses over the entire life of the loan, poses unique challenges as common equity tier 1 (CET 1) and tier 1 capital levels will be reduced without any underlying change to risk exposure or economic conditions.

Regulators have acknowledged the potential negative impact on capital related to the rule change, and as a result, recently issued a joint proposal to provide banks with the option to phase in the "day one" regulatory capital impact of the CECL accounting methodology over a three-year period. While this phase-in can temporarily soften the regulatory capital impact, experience with previous regulatory phase-in periods suggests that key stakeholders (i.e., investors, rating agencies, etc.) typically presume the fully phased-in outcomes when analyzing banks. While the Council is supportive of the phase-in, it believes more must be done.

One concern conveyed by the Council members is that, with respect to pro-cyclicality, the "day one" regulatory impact of CECL is not an improvement over the previous incurred-loss methodology. As an example, several industry CECL back-tests performed prior to and during the Great Recession showed that using base economic forecasts at the time of reserve-setting did not generate a materially different timing of "reserve build" than what actually occurred under previous accounting methodologies. Furthermore, the timing issue was exacerbated by reserve peaks, which resulted in levels 50% to more than 100% higher than what occurred under the prior methodology. In these modeled scenarios, the significantly higher levels of the allowance for loan and lease losses during a downturn would strain regulatory capital ratios, which would be countercyclical and adversely affect the availability and affordability of credit to key constituents.

The Council believes that, without a regulatory capital adjustment, CECL will have significant and adverse impacts on the pricing, terms, and supply of credit for longer-dated credit products (mortgage loans, student loans, project finance) and will provide an incentive for banks to reduce lending to riskier customers. The role of maturity transformation that banks provide will be negatively impacted by the adoption of CECL, absent regulatory capital adjustment, and the new accounting around CECL provisions would in effect be driving credit allocation decisions by banks and for the economy.

The Council believes that the solution to this issue is for bank regulators to either recalibrate downward regulatory capital minimums or to allow a CET 1 credit for the additional loss absorbency on banks' balance sheets resulting from the CECL provisions. These higher reserves are more closely related to unexpected losses (i.e., capital). Making this type of adjustment would leave banks in a comparable place, in terms of capital available to lend and their lending risk appetite, as they are in today. The measurement and methodology for such an adjustment could be somewhat tricky and complex and would therefore require analysis and study.

Council members also noted how the intersection of CECL and the Comprehensive Capital Analysis and Review (CCAR) could amplify losses and, in all likelihood, bring losses forward in CCAR stress tests, based on the reserving methodology described in the Federal

Reserve's 2013 "Range of Practices and Expectations" document. The Council is hopeful that CCAR will optimally include CECL in a manner that promotes transparency and comparability, represents firm-specific credit risk, and is consistent with how the allowance would work in an actual stressed environment. The Federal Reserve Board staff has held two meetings with the industry to discuss this issue, and has asked the industry to make methodology proposals for how CECL should be modeled in CCAR. As this work is being done, the Council believes it will be important for the Board to communicate, as quickly as possible, its expectations for appropriate methodologies, guardrails, and assumptions for CECL-reserving in CCAR 2020.

3. Conducting a study to understand both the impact of CECL in different economic environments and the differences in global provisioning standards (CECL vs. IFRS 9).

Council members noted that CECL implementation may create higher costs for banks, which could lead to unintended consequences for borrowers of longer-tenor products (for example, home mortgage, home equity, student, and selected consumer finance loans). Potential consequences include higher rates, lower loan availability, or structural changes to loans that would shorten their tenor. This potential negative impact on customers could make it more difficult for banks to play their important role as financial intermediaries. Although it is difficult to fully anticipate all of the unintended consequences CECL could have on loan markets and products, a Council member highlighted how Canada is already noting changes to its residential mortgage renewals due to the IFRS 9 implementation in January 2018. Although the Canadian residential mortgage market is different from the U.S. market, the effects in Canada could serve as a potential case study for the United States, as part of a larger effort to fully understand how CECL will impact borrowers in the U.S. loan market.

A second issue raised by the Council is whether U.S. banking entities that have global footprints would be disadvantaged relative to their U.K./European counterparts, given differences in global provisioning standards (CECL vs. IFRS 9). Considering the potential real-world impacts of CECL and potential differences in global provisioning standards, Council members believe further study would be constructive.